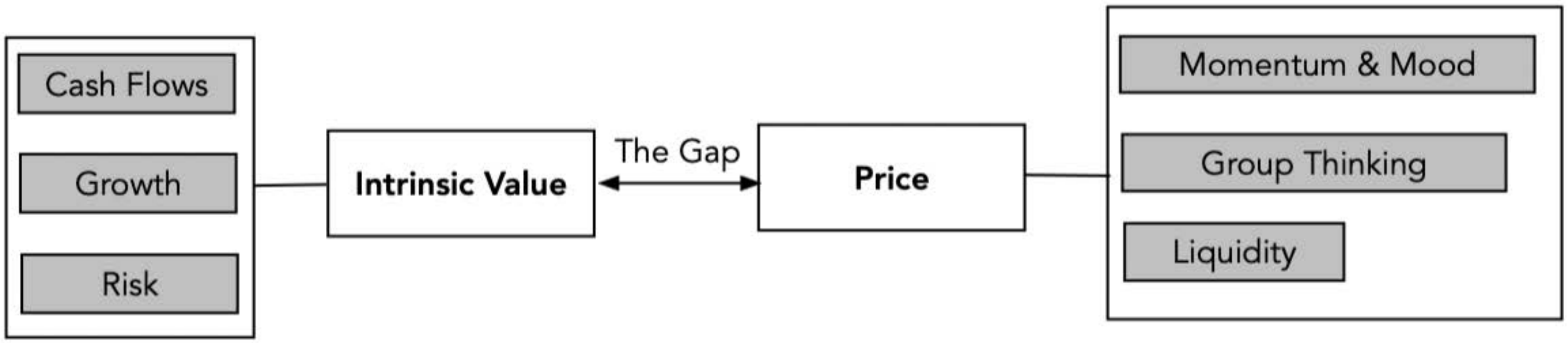
VALUE INVESTING III: REQUIEM, REBIRTH OR REINCARNATION!

The Lead In

Value Investing has lost its way!

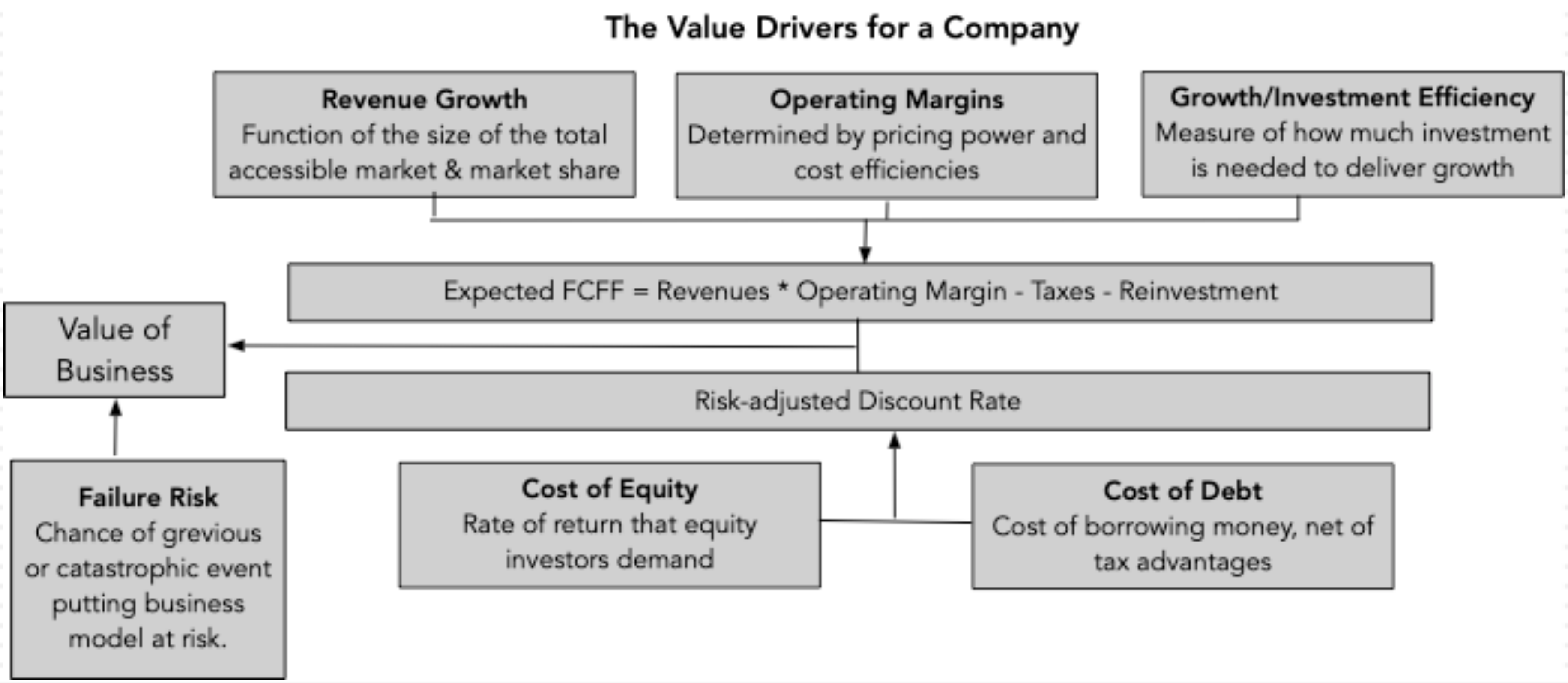
- It has become rigid: In the decades since Ben Graham published Security Analysis, value investing has developed rules for investing that have no give to them. Some of these rules reflect value investing history (screens for current and quick ratios), some are a throwback in time and some just seem curmudgeonly. For instance,
  - Value investing has been steadfast in its view that companies that do not have significant tangible assets, relative to their market value, and that view has kept many value investors out of technology stocks for most of the last three decades.
  - Value investing's focus on dividends has caused adherents to concentrate their holdings in utilities, financial service companies and older consumer product companies, as younger companies have shifted away to returning cash in buybacks.
- It is ritualistic: The rituals of value investing are well established, from the annual trek to Omaha, to the claim that your investment education is incomplete unless you have read Ben Graham's Intelligent Investor and Security Analysis to an almost unquestioning belief that anything said by Warren Buffett or Charlie Munger has to be right.
- And righteous: While investors of all stripes believe that their "investing ways" will yield payoffs, some value investors seem to feel entitled to high returns because they have followed all of the rules and rituals. In fact, they view investors who deviate from the script as shallow speculators, but are convinced that they will fail in the "long term".

1. Be clearer about value vs price..

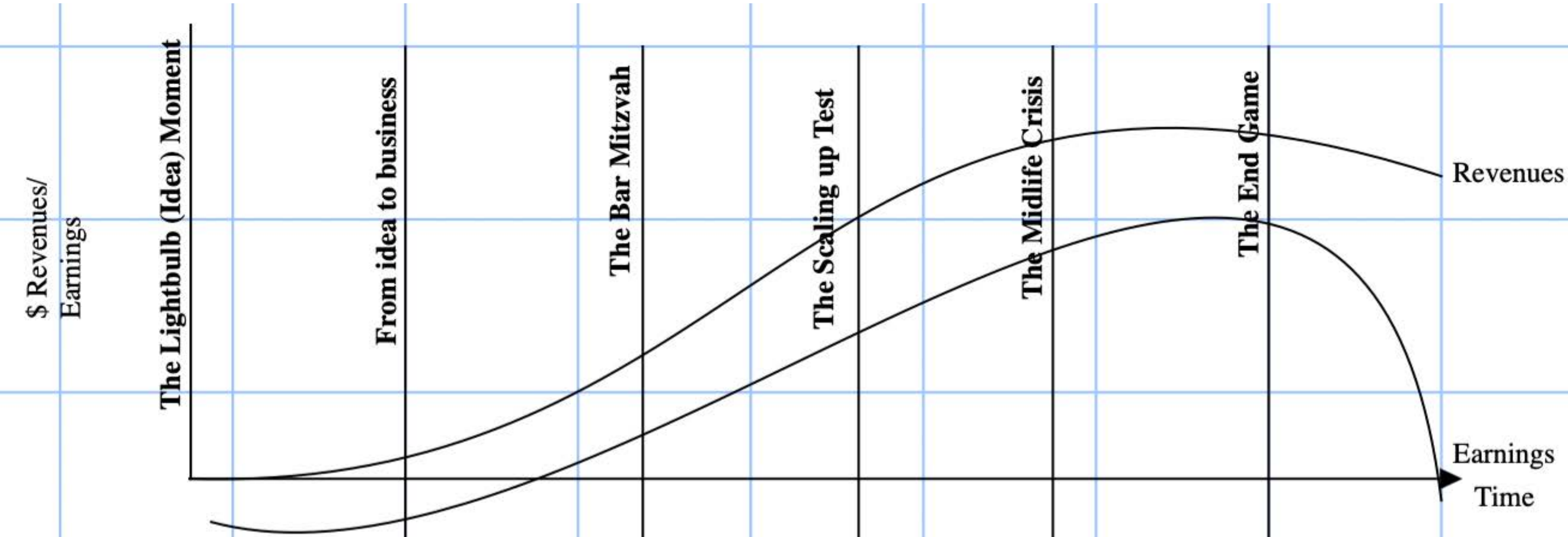


- *Value is a function of cash flows, growth and risk*, and any intrinsic valuation model that does not explicitly forecast cash flows or adjust for risk is lacking core elements.
- *Price is determined by demand and supply*, and moved by mood and momentum, and you price an asset by looking at how the market is pricing comparable or similar assets.
- Many value investors seem to view discounted cash flow valuation as a speculative exercise, and instead pin their analysis on comparing comparing on pricing multiples (PE, Price to book etc.).

Value Drivers…

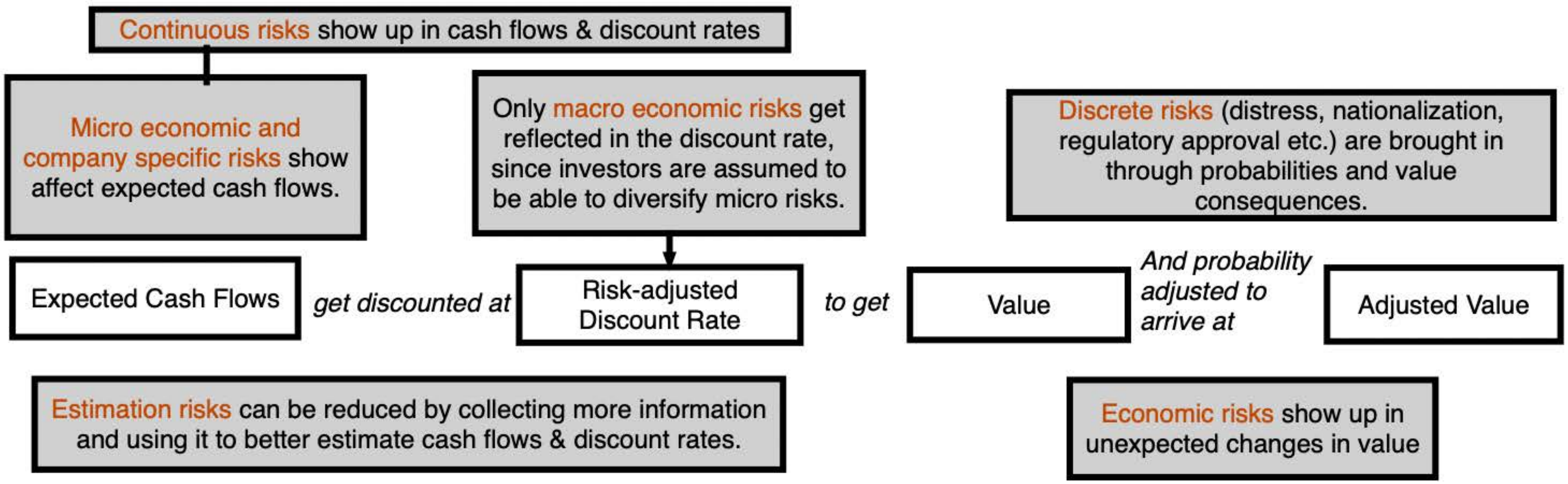


2. Avoiding uncertainty cannot be the end game…

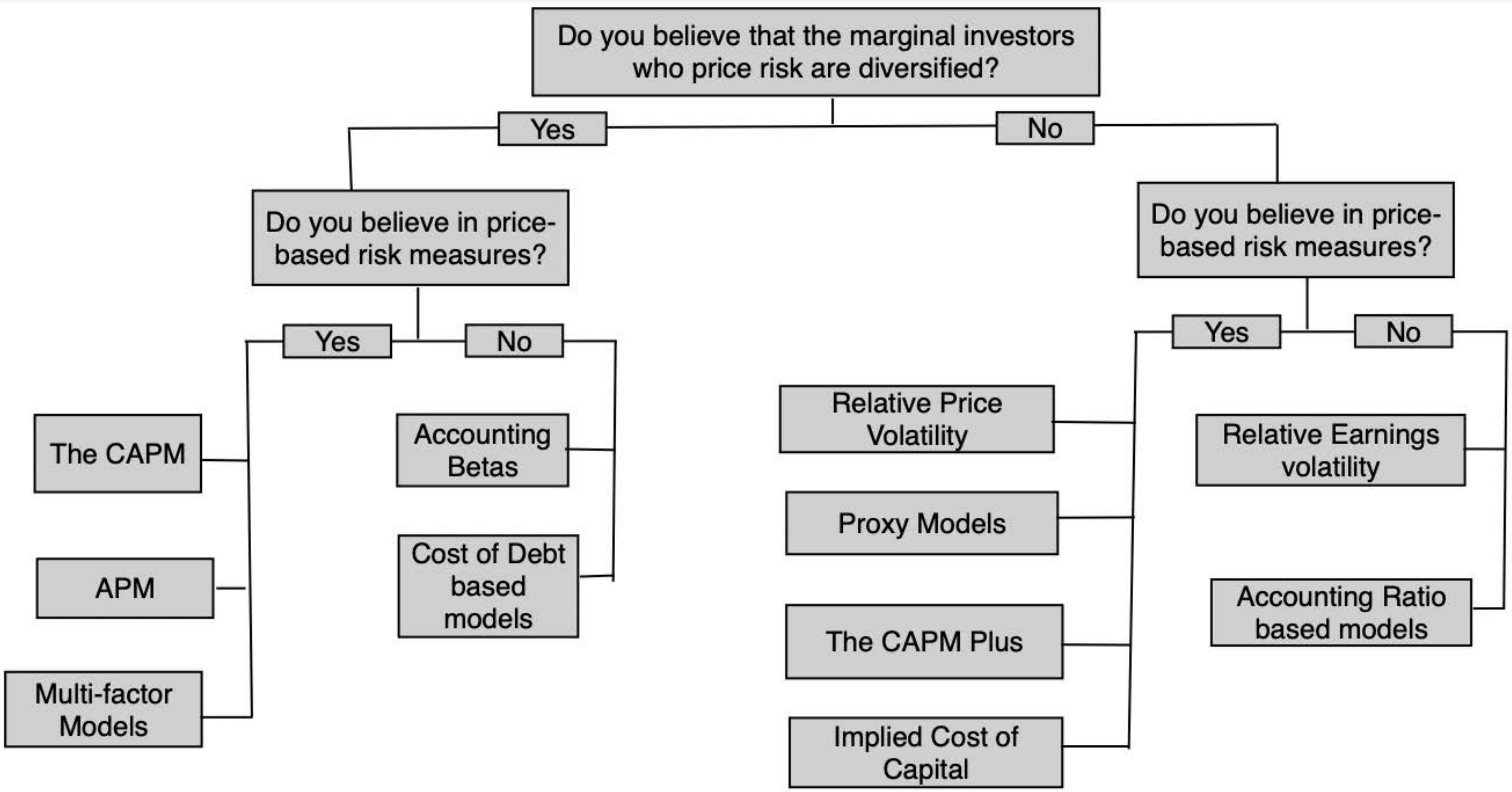


Growth stage	Stage 1 Start-up	Stage 2 Young Growth	Stage 3: High Growth	Stage 4 Mature Growth	Stage 5 Mature Stable	Stage 6 Decline
Uncertainty about	Does the idea have potential?	Is there a business model for the idea to be commercialized?	Will the business model generate profits?	Can the business be scaled up?	Can the business be defended?	Will management face reality?
Type & Magnitude	*High & company specific*					*Low & sector or macro driven*

Build uncertainty into your valuations…



3. The Margin of Safety is not a substitute for risk assessment…



And increasing MOS creates a trade off…

		The Truth	
		Stock is under valued	*Stock is over valued*
Your Analysis	*Stock is under valued*	A Good Buy	Type 1 investment error: Buy the wrong stock or fail to sell the right stock.
Your Analysis	*Stock is over valued*	Type 2 investment error: Fail to buy the right stock or sell the wrong one.	A Good Sell

Reduces the chance of type 1 error

Increases the likelihood of type 2 error

Higher Margin of Safety

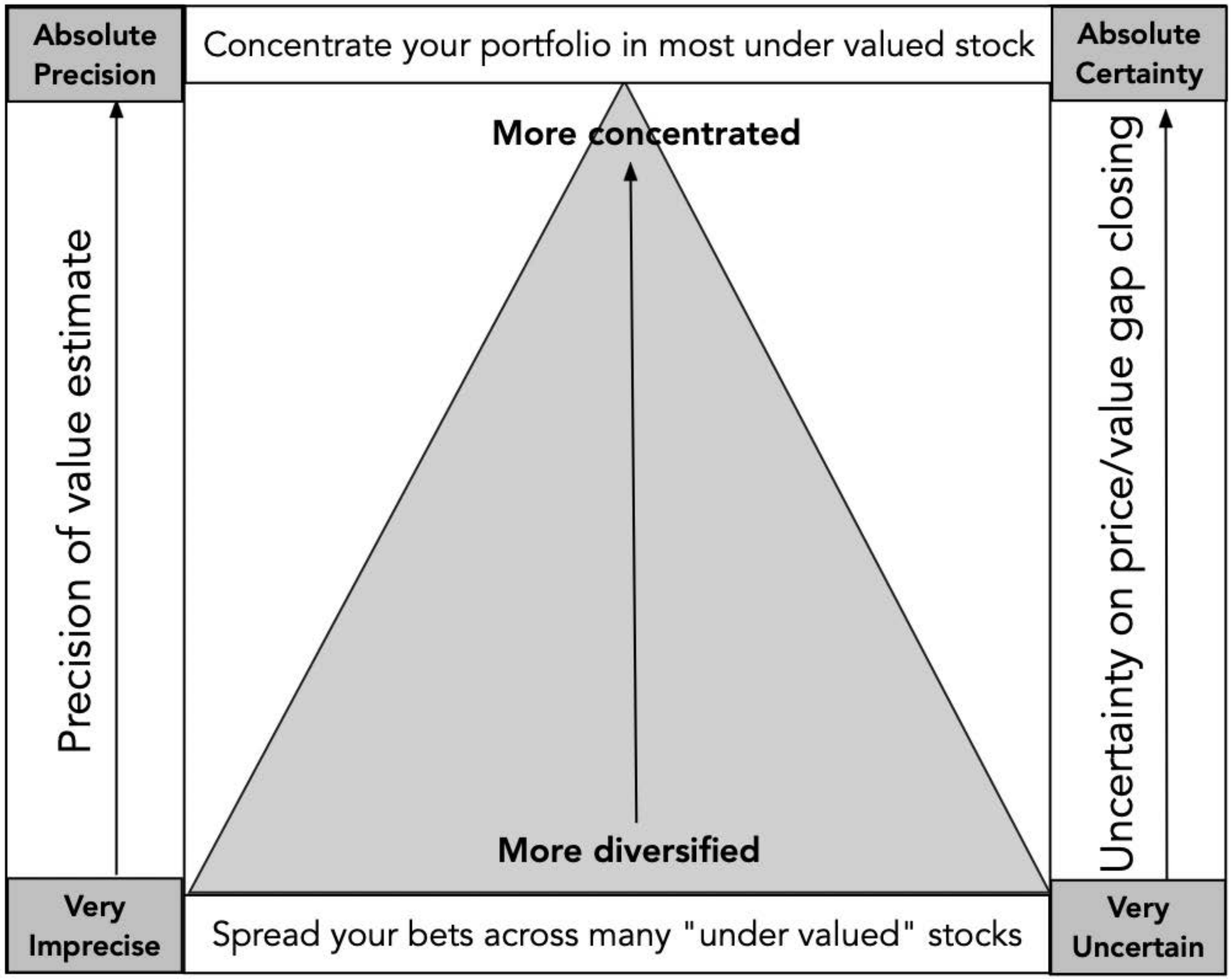
4. Don’t take accounting at face value… Or look to accounting rules for salvation..

- It is undeniable that value investing has an accounting focus, with earnings and book value playing a central role in investing strategies.
- There is good reason to trust those numbers less now than in decades past, for a few reasons.
  - One is that companies have become much more aggressive in playing accounting games, using pro forma income statements to skew the numbers in their favor.
  - The second is that as the center of gravity in the economy has shifted away from manufacturing companies to technology and service companies, accounting has struggled to keep up. In fact, it is clear that the accounting treatment of R&D has resulted in the understatement of book values of technology and pharmaceutical companies.

5. You can pick stocks and be diversified… At the same time…

- While not all value investors make this contention, a surprisingly large number seem to view concentrated portfolios as a hallmark of good value investing, arguing that spreading your bets across too many stocks will dilute your upside.
- The choice of whether you want to pick good stocks or whether you want to be diversified is a false one, since there is no reason you cannot do both.
- After all, you have thousands of publicly traded stocks to pick from, and all that diversification requires is that rather than put your money in the very best stock or the five best stocks, you should hold the best thirty or forty stocks.

Concentration vs Diversification



6. Don’t’ feel entitled to a reward for your virtue…

- Investing is not a morality play, and there are no virtuous ways of making money. The distinction between investing and speculating is not only a fine one, but very much in the eyes of the beholder.
  - To hold any investing philosophy as better than the rest is a sign of hubris and an invitation for markets to take you down.
  - Keeping an open mind about other investment philosophies can not only keep you grounded but allow you to incorporate aspects of those philosophies into your own.
- If you are a value investor, that is your choice, but it should not preclude you from treating other investors with respect and borrowing tools to enhance your returns.